STANDBY LETTERS OF CREDIT –
WHY CREDITORS PREFER THEM TO GUARANTEES

I Introduction – Commercial and Standby Credits

A letter of credit is an undertaking by the *issuer* of the credit, normally a bank, given to the *beneficiary* of the credit, to pay the beneficiary upon the presentation of the documents specified in the letter of credit.

Practitioners distinguish between *commercial* letters of credit and *standby* letters of credit. A commercial letter of credit typically supports an international sale of goods. The issuing bank undertakes in the commercial credit to pay the purchase price of the goods to the beneficiary, the seller, upon the presentation of the documents typically delivered by a seller in a sales transaction (such as an invoice, a transport document and an insurance certificate).

A *standby* letter of credit, by contrast, typically supports the payment of a financial obligation other than payment for the purchase of goods. The issuing bank undertakes to pay the beneficiary, the obligee in the underlying financial transaction, upon presentation of a statement by the obligee, such as a statement that the obligor is in default in the underlying financial transaction.

A second distinction between commercial and standby credits considers whether the parties expect the letter of credit to be used. A commercial letter of credit is a payment mechanism under which the parties *expect the beneficiary to present documents* and that the bank will pay the beneficiary, thereby consummating the sale of goods. By contrast, the beneficiary in a standby credit is typically expected to present documents under the credit *only if there is a default* in the underlying transaction. In a standby letter of credit, the issuer "stands by," just in case something goes wrong in the underlying transaction. Thus, the standby credit in function is similar to a guarantee.

This article discusses only standby letters of credit.

II Illustrative Example

Suppose that the lender and borrower are parties to a $500,000 Loan Agreement, and the agreement provides that the borrower's obligation to repay the loan will be supported by a letter of credit. To obtain the letter of credit, the borrower applies to a bank. The bank agrees to issue the credit to the lender, and the borrower agrees that if the bank is called upon to pay the lender and does so, the borrower will reimburse the bank. In order to be paid under the credit, the lender must present to the bank a default certificate, that is, a document that states

> This demand is made pursuant to Standby Credit No. 12345 (issued January 15, 2004). The undersigned Lender certifies that Borrower is in default under the Loan Agreement between Borrower and Lender dated December 15, 2003. The amount of $________ is due and owing thereunder, and demand is hereby made for the said sum.

Standby letters of credit often provide for the presentation of a draft drawn on the issuing bank. In our example, if a draft is to be presented and the borrower has defaulted in the amount of $50,000, the draft might appear as follows:

Drawn on Issuing Bank Standby Letter of Credit No. 12345______
____________, 2004
__________At Sight_____________________________
Pay to the order of ____Lender_____$____U.S. $50,000_
____Fifty Thousand_______________U.S. Dollars___

To: Issuing Bank
[Address__________]   r
Lender
By__________
(Name) (Office)

The draft would be a negotiable instrument subject to Articles 3 and 4 of the Uniform Commercial Code.

The three parties in this illustrative letter of credit transaction are

(i) the borrower,

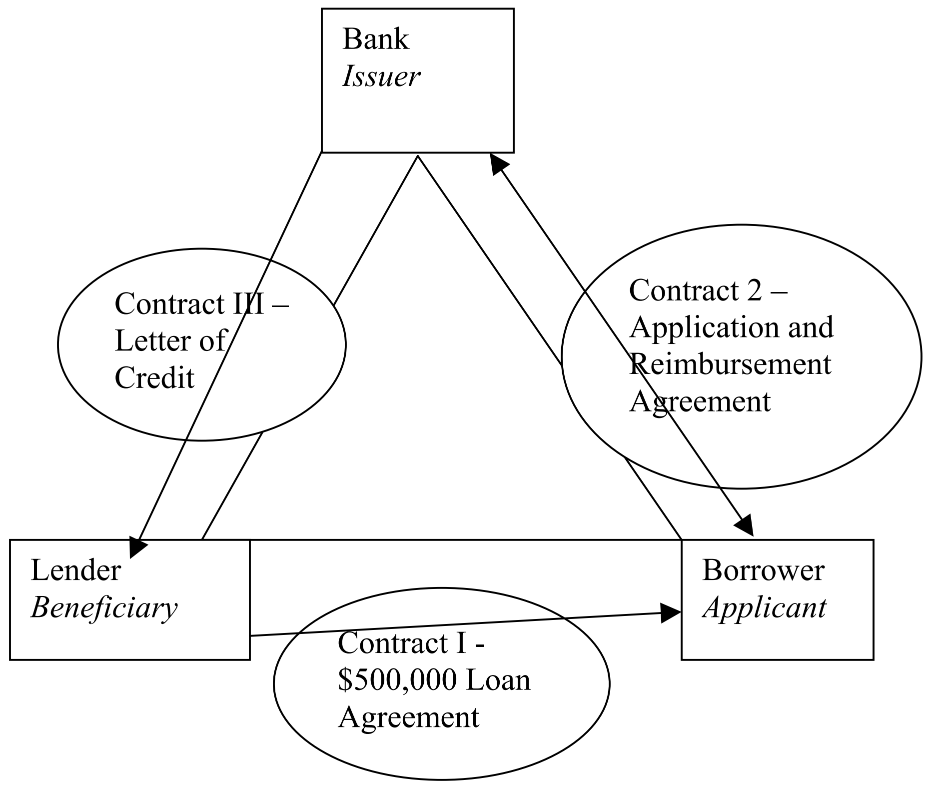
(ii) the lender and

(iii) the bank.

In letter of credit parlance, the borrower is the *applicant*, the lender is the *beneficiary* and the bank is the *issuer* or *issuing bank*. The structure of every letter of credit consists of three contracts. In our example,

1) Contract I is the underlying transaction, the $500,000 Loan Agreement between the borrower and the lender.
2) Contract II is the borrower's application to the bank for the issuance of a credit and the borrower's agreement to reimburse the bank, and
3) Contract III is the letter of credit.

The letter of credit, Contract III, supports the underlying transaction, Contract I, and in Contract II, commonly called the "application agreement" or the "reimbursement agreement," the applicant agrees to reimburse the issuer if the issuer pays the beneficiary. The three-contract structure of the transaction in our example is illustrated below.



The bank engages in the standby credit to pay the beneficiary upon the presentation by the beneficiary of (i) the default certificate worded as described above and (ii) the draft. The presentation of documents for payment pursuant to a letter of credit is called a *draw*. The letter of credit specifies an expiration date, called the *expiry*. The bank is not obliged to honor a presentation of documents made after the expiry.

The issuer is typically the applicant's bank. Many letter of credit transactions include another bank located in the same location as the beneficiary. Suppose that in our example, the applicant-borrower and the issuing bank are located in Prague, and the beneficiary-lender is located in Chicago. For the convenience of the Chicago beneficiary, the issuing bank might agree that a bank in Chicago will act as an *advising bank*.

The advising bank in Chicago could be authorized by the issuing bank to notify the Chicago beneficiary that the credit has been issued by the bank in Prague and advise the beneficiary of the terms of the credit. The advising bank might also be authorized to accept the beneficiary's draw documents in Chicago on behalf of the issuer in Prague.

In addition, the advising bank in Chicago might be authorized to pay the beneficiary if the presented documents conform to the requirements of the credit. A bank that is authorized to honor a complying presentation is called a *nominated bank*. A nominated bank may also *confirm* the credit; that is, make the same engagement to the beneficiary as the issuer has made and thus become obligated to honor a complying presentation. The issuing bank must reimburse a nominated bank that honors a complying presentation.

III Uses of Standby Letters of Credit

Standby letters of credit can be used to support virtually any kind of obligation in which the performance of the obligor is executory, that is, to occur in the future. They have commonly been used

a) To enhance the credit rating of commercial paper
b) As a security deposit under a lease in lieu of a deposit of cash
c) To support the reclamation obligations of mining companies
d) To support the debt service obligations of developers in municipal bond financings

e) To support the obligations of sureties under supersedeas litigation bonds pending the outcome of an appeal..

IV Sources of Letter of Credit Law

A. Uniform Commercial Code

In the United States, the rights and obligations of the parties under letters of credit issued in the United States are governed by Article 5 of the Uniform Commercial Code. Generally, the fundamental principles of letter of credit law described in Section V below are embodied in U.C.C. Article 5. Article 5 also covers fraud, described in Section VI below.

B. The International Chamber of Commerce

The International Chamber of Commerce (ICC), headquartered in Paris, has monitored developments in letter of credit practice and issued rules to govern that practice since the 1930s. These rules include

(i) the *Uniform Customs and Practice for Documentary Credits* (the UCP) and

(ii) the *International Standby Practice* (the ISP).

Either the UCP rules or the ISP rules apply to a letter of credit when the credit explicitly incorporates the rules by reference.

The UCP rules were designed initially for the examination of documents presented under commercial letters of credit, but many standby credits have been made subject to the UCP as well. The ISP rules, which were adopted effective in 1998, were designed to apply only to standby credits. Since the adoption of the ISP, it seems to have been the growing practice to incorporate the ISP rather than the UCP in standby credits.

In a number of important respects, the ISP rules may be thought unfair to beneficiaries and applicants (s*ee* B. Wunnicke, D. Wunnicke and P. Turner, *Standby and Commercial Letters of Credit* (2003 Supplement), Chapter 6); but the ISP rules rightly omit UCP rules that are inappropriate for standby credits. Certainly from the bank's point of view, the ISP rules are clearly preferable to those of the UCP for standby credits.

V Fundamental Principles of Letter of Credit Law

Three fundamental principles of letter of credit law and practice should be noted:

(1) the "independence principle," isolating the credit from the underlying transaction,

(2) the "strict compliance" doctrine to determine the compliance of documents, and

(3) the "preclusion rule," requiring the issuer promptly to assert any discrepancies in the documents.

(A) The Independence Principle

The issuer is obliged to pay the beneficiary provided only that the documents presented to the issuer by the beneficiary conform to the specifications in the letter of credit. The independence principle declares *that the obligation of the issuer to the beneficiary to honor the credit is independent of the rights and obligations of the parties in the underlying agreement and in the reimbursement agreement* (UCP Article 5 – UCC Section 5103(d), ISP Rule 1.06(c)).

Walls are conceptually erected between Contracts I, II and III. Thus, any defense the obligor may have to payment of the obligee in the underlying transaction is not available to the bank as grounds for dishonor under the letter of credit.

In our example, the borrower may honestly believe that it need not pay the lender. Perhaps the Loan Agreement has been restructured and the right to payment of a particular installment is in dispute, or perhaps a third party claims to be a successor obligee as a result of a merger that is the subject of a dispute. Such circumstances as these – although they might constitute grounds for the borrower to decline or defer payment to the lender in the underlying transaction – would not justify the bank's dishonor of the beneficiary's presentation of complying documents under the standby credit.

(B) "Strict Compliance"

The documents presented by the beneficiary must *strictly* comply with the requirements of the credit. The courts have generally rejected less rigorous standards of compliance, sometimes formulated as "reasonable compliance" or "substantial compliance."

In our illustration, the beneficiary is required to present a certificate stating "The undersigned Lender certifies that Borrower is in default under the Loan Agreement between Borrower and Lender dated December 15, 2003." If instead, the certificate states "Borrower was supposed to pay us $50,000 on January 10 but so far has not done so," the certificate would not comply with the requirements of the credit, and the bank would not be obliged to honor the presentation.

"Strict compliance," however, does not mean slavish imitation. The wording in a presented document need not duplicate a spelling error or a trivial difference in the wording in the letter of credit. In our illustration, the certificate is supposed to state: "This demand is made pursuant to Standby Credit No. 12345 (issued January 15, 2004)." If instead, the certificate states: "This demand is made pursuant to Standby Credit <u>**Number**</u>

12345 (issued **Jan**. 15, 2004)," the bank's refusal to honor the presentation would be wrongful.

(C) The Issuer's Preclusion

The bank must give timely notice when it determines to dishonor the credit, specifying the discrepancy on which it bases the determination. The time generally allowed is a "reasonable" time, *not exceeding seven banking days* after the date the documents are presented (UCP Article 14 (e) – ISP Rule 5.01(a)(i) - UCC Section 5-108(c)). (Under ISP rule 5.01(a)(1) the bank is allowed at least three business days as a not unreasonable time to respond under a standby credit.) If timely notice of dishonor is not given, the issuer must honor the credit.

VI Fraud

When a document is materially fraudulent or payment would facilitate a material fraud, the independence principle does not apply. Under the fraud exception to the independence principle, the issuer, acting in good faith, may refuse to honor the presentation even though the documents are not strictly compliant. If the issuer determines to pay despite the applicant's claim of fraud, a court may enjoin payment by the issuer.

The fraud exception to the independence principle is narrowly construed by the courts. If injunctive relief were readily available on grounds of fraud, the letter of credit would lose its utility as a swift and certain payment mechanism. Thus, the courts have been urged to grant injunctive relief only when convincing evidence of material fraud indicates that the beneficiary has no colorable right to expect to be paid and there is no basis in fact to support the beneficiary's right to be paid.

VII Standby Credits vs. Guarantees

Standby credits and guarantees perform the same function: they both support the performance of the obligor in the underlying transaction. There are, however, two fundamental differences between the two types of instruments, and these differences make the standby credit clearly preferable to the guarantee from the creditor's point of view.

First, a typical guarantee is a "secondary obligation," that is, the obligation of the guarantor under the guarantee is secondary to, and dependent upon, the obligation of the obligor in the underlying transaction. If the obligor in the underlying transaction is not in breach or has a defense to payment, the guarantor is not obliged to pay under the guarantee.

The standby credit, by contrast, is a "primary obligation." The issuer is obliged to pay the beneficiary so long as the beneficiary presents the documents stipulated under the credit. Whether the applicant is in default under the underlying transaction is irrelevant.

The second fundamental difference is that standby credits are not subject to the traditional defenses available against guarantors. (*See*, for example, Cal. U.C.C. § 3605). Moreover, a beneficiary may draw under a letter of credit in connection with commercial real property in California, *even when the result might otherwise have conflicted with California's anti-deficiency rules*. (Cal. Civil Code § 2787, and see *Western Security Bank, N.A.. v. Beverly Hills Business Bank*, 37 Cal. Rptr. 2d 840 (Cal. 1995), 15 Cal. 4th 232.)

To illustrate the superiority of the standby credit from the creditor's point of view, suppose that Eastern Crude Oil regularly purchases crude oil from Standard Crude Sales.

Standard asks Eastern to provide either a standby letter of credit to support its obligation to pay for the crude oil or a guarantee of its obligation to pay by Eastern's parent corporation, Eastern Petroleum.

Scenario 1 - Standby Letter of Credit.

Eastern Crude Oil provides a standby letter of credit issued by First San Francisco Bank. Eastern Crude Oil then defaults in its obligation to pay Standard for Eastern's crude oil purchases.

Standard draws under the letter of credit by providing a certificate to First San Francisco Bank: "Eastern is in default under its obligation to pay Standard for Eastern's crude oil purchases." Seven banking days pass. The preclusion rule applies, and the bank becomes obliged promptly to pay Standard under the letter of credit.

Scenario 2 - Parent Guarantee.

Eastern Crude Oil provides Standard with a guarantee of its parent, Eastern Petroleum. Eastern Crude Oil then defaults in its obligation to pay Standard for Eastern's crude oil purchases.

Standard sends a letter to Eastern Petroleum demanding payment under the guarantee. Ten months go by without an answer.

After 10 months have gone by, Eastern Petroleum answers Standard's letter: "We understand that Eastern Crude Oil has several defenses to payment based upon deficiencies in previous deliveries of crude oil. Our obligation under the guarantee is a secondary obligation. Since Eastern Crude is not obliged to pay for the crude, we are not obliged to pay under the guarantee."